THE INSTITUTE OF CHARTERED ACCOUNTANTS OF SRI LANKA

# COMMON PRE-SEEN CASE STUDY

# (KC1 TO KC4)

# JUNE 2015

# Lanka Foods (Pvt) Limited

Lanka Foods (Pvt) Limited (LFPL) was founded by Sarath Kariyawasam in 1970, during a closed economic political era, where the focus was on promoting local products and reducing imports. He had inherited the entrepreneurial flair of his father who migrated to Colombo from Galle in the early 1950s and started a chain of agri outlets called **"Lanka Foods"** in key towns. These outlets sold the farm produce harvested from their own two large farms located in the Kurunegala and Polonnaruwa districts. Both farms had herds of dairy cattle for milk production as well as vegetables grown with traditional manure. Sarath's father who had no formal education believed that Sri Lanka could be self-sufficient in most consumer staples.

Sarath got the opportunity to study in Colombo and graduated from the University of Peradeniya with a Bachelor of Commerce degree. Instead of joining the family business, he opted to work in a reputed private company for almost 10 years, firstly as a graduate trainee and then progressing to a middle management position. Sarath joined his family business Lanka Foods as the General Manager in 1965. His father retired in 1969 after handing over full management control to Sarath. The business was incorporated in 1970 as Lanka Foods (Pvt) Limited (LFPL).

Sarath had no major funding constraints as leading government banks in the 1970s supported his expansion, which was based on promoting local products. He expanded the "LFPL" product portfolio from the traditional dairy based products (i.e. yoghurt, curd etc.), farm fresh fruits and vegetables, to a processed food range consisting of pickles, chutneys, curry and spice mixes. These were produced from his own two farms and any raw material shortfall was purchased from the surrounding local farmers. He also allocated a few acres from the farmland to grow teak and mahogany as a future investment. Sarath increased his production capacity by recruiting low cost, unskilled labour from surrounding villages and doubled the "Lanka Foods" agri outlet locations from 10 outlets in 1970 to 20 by 1975. The business turnover tripled during this period. He closed down unprofitable locations and opened up new outlets on main highways offering refreshment facilities, and his agri outlets became popular journey breakers for both private and public transport vehicles. He invested in land in the Puttalam area for a third farm in order to satisfy the growing demand. As labour was cheap, he opted for traditional, labour-intensive production methods. His regular customers appreciated the "home–made and authentic" feel of the LFPL portfolio. Sarath was strengthening his processed food range with farm fresh jams and sauces when the 1977 general election in Sri Lanka changed the economy to a market friendly and competitive landscape.

The liberalised economy brought greater economic freedom and choice to the Sri Lankan consumers, but posed many challenges to home grown enterprises like LFPL. The competition posed by new entrants i.e foreign multi-national companies expanded the processed food options available and were backed by superior marketing and distribution networks. The Sri Lankan corporates too modified their commercial strategies to regain the consumers' attention, in an ever increasing consumerist society. Being an astute businessman, Sarath realised that his "local goodness" proposition had lost its edge with emerging new trends on brand preference, perceived quality, ease of access and marketing capability. Sarath had to struggle hard in the 1980s to keep pace with the changes. His clientele visiting the agri outlets began to dwindle, impacting both turnover and profitability. Moreover, the labour turnover increased as many new jobs were created in the apparel and other manufacturing industries. His competitors resorted to semi-automation in food processing and located their production centers closer to agricultural areas, procuring raw materials by developing farmer networks, instead of holding on to large farmland.

Sarath struggled hard up to the mid-1990s with serious cash flow issues and dwindling margins undermining the business survivability. He took critical decisions to sell part of the unproductive farmland and built a network with farmers surrounding his farms. His attempt to distribute the LFPL portfolio to large retailers failed as retail distribution required dedicated partners and sales staff. As a hedging strategy, with his personal contacts in Australia and Canada, Sarath started an export business which was accepted by the older generation of the Sri Lankan diaspora. However, his overall financial situation remained serious. Sarath remembers the 1990s as the decade of survival.

Sarath's daughter Sureka Kariyawasam, armed with a Chartered Accountancy qualification and a local MBA, joined the business in early 2006. She studied the business for 2-3 years and was of the opinion that apart from funding issues, the business had to be re-engineered, considering its inefficient supply chain. With some reluctance, Sarath who by this time had assumed a more advisory and mentoring role, agreed with the series of new initiatives. Sureka implemented them from 2010 to regain the customers.

In 2012, Sureka introduced a new IT/Business Tracking System which enabled her to identify the key costs and their variances on a monthly basis. She also brought in part-qualified finance and IT staff at competitive rates which ensured faster flow of information, debtor tracking and better customer service. Sureka also realised the need to expand its product availability beyond the agri outlets and hired a sales consultant, who negotiated with key supermarkets and leading retailers to stock a selected range. The packaging too was modified with the help from a design agency to give a contemporary image, whilst preserving the product heritage. A new sales team was recruited as most supermarkets and large retailers expect prompt service and tend to delay payments as a trading practice. These improvements resulted in a significant increase in the performance of the company.

Further, after studying the competitor business models, Sureka took a bold step to sell the farmland in Polonnaruwa and Puttalam. Accordingly, the Polonnaruwa land was sold in 2012 and the Puttalam land was sold in 2013. Proceeds received from the sale of land were invested in fixed deposits and long term bonds issued by Handsome PLC.

Sureka decided to retain the Kurunegala farm and centralise the manufacturing facilities there. She justified retaining the Kurunegala farm on two grounds;

(i) It consists of fairly substantial teak, coconut and mahogany cultivation

(ii) Many fruits and vegetables required for the business could be sourced from the area.

With the support from the Regional Chamber of Commerce, she developed a strong network of farm produce suppliers from the Kurunegala district, with regular payouts for their services.

## Future direction and strategies

Sureka also realised that the company's outdated production technology is a strain on its margins. Obtaining the latest production technology will require an investment of Rs. 1 billion. This will bring down the cost of production substantially and increase the quality of the product as well. Sureka expects that this process will result in an increase in local sales as well as export sales. Sureka was looking for possible funding strategies for this investment and met senior managers of many commercial banks and development banks to obtain their financial support. Further she looked for a foreign investor to invest in equity shares of the company. In August 2014 she went to India to participate in an exhibition where she met the managing director (MD) of Partha Sarathi PLC (PSP). PSP is an influential Indian trading company with strong regional contacts. Sureka explained to the MD of PSP about her business and managed to convince them to invest Rs. 500 million in her business (LFPL) in mid-2015, offering them a seat on the family dominated LFPL's board. Sarath's advice to Sureka was to look into local fiscal requirements when bringing in external funds and board re-formulation. Sureka convinced her father that LFPL should progress to a listed company by 2015 or 2016. Further she convinced her father that inviting good calibre people to the board is required to strengthen the profile of the business.

PSP's management has already identified refurbished Indian plants which are semi-automated. These machines may reduce production cadres significantly and PSP was pushing Sureka to accept the Indian machines. If accepted, the value of the machinery will be considered as part of the investment.

Sureka guided by the sales consultant wants to establish a strong network with leading exporters of Sri Lankan products to Australia, New Zealand, Italy and Canada to drive her export volumes, which is expected to pick up after factory modification and improved quality standards. Sarath realised that business is on the way up, but was concerned about possible staff retrenchment and loss of the founder's principles over time.

Sureka, before consenting to the Indian machinery option, is also contemplating to invest the funds from PSP to acquire 60% of ownership in Northern Foods (Pvt) Limited. The assets belonging to Nothern Foods as at 31 December 2014 are given below.

| **Item** | **Rs. million** |
|---|---|
| Land and buildings | 329 |
| Plant and machinery | 115 |
| Trade receivables | 75 |
| Inventory | 22 |

Northern Foods is currently owned by Charles Sellamuttu and he has good relationships with 3 large foreign retail chains in Europe and Australia. He is currently selling his packaged food products under the "Charlie's" brand name.

If Northern Foods is acquired, it can be leveraged to manufacture products for export purposes.

Sarath's advice to Sureka is to move cautiously, prioritising on emerging market conditions.

## Other information

LFPL prepares the financial statements based on the full version of Sri Lanka Financial Reporting Standards. The following salient features could be identified in relation to the accounting practices/policies and financial statements of the company.

(i) Biological assets belonging to the company have been shown at fair value in the financial statements.

(ii) Investments in fixed deposits and bonds have been classified as available-for-sale (AFS) financial assets.

(iii) Audited financial statements for the year ended 31 December 2014 of the company carries a qualified opinion on the impairment of trade and other receivables.

(iv) The company has decided to follow integrated reporting in compiling its 2014 annual report.

(v) 4 year summary financial information is given in Annexure 1.

LFPL is also registered with the Department of Inland Revenue as a registered identified purchaser for the purpose of VAT. During the financial year 2014, the company received two assessments from the Department of Inland Revenue. One assessment related to income tax whereas the other one related to VAT. There was a disagreement between the company and the Department of Inland Revenue over the income tax rate applicable to the company and the income tax assessment was related to this disagreement.

## Annexure 1

Lanka Foods (Pvt.) Limited
Income statements for the years ending 31 December
(In Rs. million)

| | **2011** | **2012** | **2013** | **2014** |
|---|---:|---:|---:|---:|
| Revenue | 2,203 | 2,688 | 3,225 | 3,806 |
| Cost of sales | 1,652 | 1,989 | 2,258 | 2,626 |
| Gross profit | 551 | 699 | 967 | 1,180 |
| Other income/gains | 9 | 220 | 252 | 8 |
| Investment income | 5 | 4 | 11 | 14 |
| Distribution expenses | 129 | 212 | 376 | 456 |
| Administrative expenses | 124 | 255 | 335 | 387 |
| Finance cost | 60 | 59 | 56 | 52 |
| Profit before tax | 252 | 397 | 463 | 307 |
| Income tax expense | 58 | 34 | 43 | 65 |
| Profit for the year | 194 | 363 | 420 | 242 |

| Lanka Foods (Pvt.)Limited<br>Statements of financial position<br>As at 31 December (in Rs. million) | | | | |
|---|---|---|---|---|
| | **2011** | **2012** | **2013** | **2014** |
| **ASSETS** | | | | |
| **Non-current assets** | | | | |
| Property, plant and equipment | 1,046 | 972 | 728 | 754 |
| Biological assets | 208 | 92 | 188 | 246 |
| Long term investment | 11 | 241 | 478 | 566 |
| | **1,265** | **1,305** | **1,394** | **1,566** |
| | | | | |
| **Current assets** | | | | |
| Inventories | 153 | 221 | 285 | 337 |
| Trade and other receivables | 551 | 672 | 762 | 967 |
| Other investments | 12 | 80 | 83 | 91 |
| Cash and cash equivalents | 8 | 3 | 18 | 20 |
| | **724** | **976** | **1,148** | **1,415** |
| **Total assets** | **1,989** | **2,281** | **2,542** | **2,981** |
| | | | | |
| **EQUITY AND LIABILITIES** | | | | |
| Stated capital | 1,250 | 1,250 | 1,250 | 1,250 |
| Retained earnings | ( 545) | (182) | 238 | 480 |
| **Total equity** | **705** | **1,068** | **1,488** | **1,730** |
| | | | | |
| **Non-current liabilities** | | | | |
| Interest bearing loans | 599 | 580 | 460 | 430 |
| Deferred tax liabilities | 18 | 19 | 12 | 20 |
| Retirement benefit liabilities | 10 | 11 | 12 | 14 |
| **Total non-current liabilities** | **627** | **610** | **484** | **464** |
| | | | | |
| **Current liabilities** | | | | |
| Bank overdraft | 180 | 77 | 11 | 3 |
| Trade and other payables | 344 | 414 | 470 | 647 |
| Income tax liabilities | 58 | 29 | 29 | 65 |
| Interest bearing loans | 75 | 83 | 60 | 72 |
| **Total current liabilities** | **657** | **603** | **570** | **787** |
| **Total liabilities** | **1,284** | **1,213** | **1,054** | **1,251** |
| **Total equity and liabilities** | **1,989** | **2,281** | **2,542** | **2,981** |